



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

Release Number: **201233017**  
Release Date: 8/17/2012  
Date: May 25, 2012  
501.00.00  
501.36.01

Contact Person:  
  
Identification Number:  
  
Contact Number:  
  
Employer Identification Number:  
  
Form Required To Be Filed:  
  
Tax Years:

Dear

This is our final determination that you do not qualify for exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(3). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

Because you do not qualify for exemption as an organization described in Code section 501(c)(3), donors may not deduct contributions to you under Code section 170. You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file. File the returns in accordance with their instructions, and do not send them to this office. Failure to file the returns timely may result in a penalty.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at

1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Lois G. Lerner  
Director, Exempt Organizations

Enclosure  
Notice 437  
Redacted Proposed Adverse Determination Letter  
Redacted Final Adverse Determination Letter



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

Date: April 19, 2012

501.00.00  
501.36-01

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Legend:

Taxpayer =  
Date1 =  
Date2 =  
\$x1 =  
\$x2 =  
\$x3 =  
\$x4 =  
\$x5 =  
\$x6 =  
\$x7 =

Dear

We have considered your application for recognition of exemption from federal income tax under § 501(a) of the Internal Revenue Code ("Code") as an organization described in § 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

**FACTS**

You, Taxpayer, were formed on Date1. You filed your application under § 501(c)(3), Form 1023, on Date2. According to your original Articles of Incorporation, your purpose is to manufacture pharmaceuticals. You later amended your Articles to provide that you are "organized exclusively for charitable, religious, educational, and scientific purposes" within the meaning of § 501(c)(3).

According to your bylaws, your vision is to "manufacture safe, effective, and affordable medicines for people in need throughout the World." Your bylaws further provide that your mission is to provide "life-saving drugs to developing countries at ultra-low cost." You represented that your decision to manufacture any specific pharmaceutical will be based on a combination of various factors, such as:

- Availability of a formula, or current non-profit research in progress;
- World Health Organization drug shortage list;
- Availability of distribution channels based on your partnerships;
- Alignment with your mission to provide life saving drugs at ultra low cost.

You have not made any specific determinations regarding which pharmaceuticals you will initially manufacture. You did not submit any additional information regarding the pharmaceuticals you are considering manufacturing, the process for seeking approval to manufacture those pharmaceuticals, or details on your intended operations. Your business model does not consider the distribution of drugs. You state that you will form partnerships with non-profit and public organizations to help with the distribution of drugs, but do not describe these partnerships in detail.

When asked to describe how you will determine pricing for your pharmaceuticals, you initially represented that your sale price will be based on the operational costs if not fully recovered by donations. Later you represented that your "GOAL is to provide pharmaceutical drugs at 'substantially below cost' to recipients . . . ." You state that the sales price will be based on your operational costs (i.e. those associated with the manufacturing site, labor, burden and material), if you are not able to cover the costs by donations. Other than a general statement that you intent to provide drugs substantially below cost if possible, you did not provide any specific information regarding your pricing.

You expect your manufacturing operations will be based in a formerly FDA approved facility. However, you did not submit any evidence of the selection of the site, including contracts, proposed locations, or information regarding approval for manufacturing pharmaceuticals.

Your four founders are lifetime members of the Board and the only directors on the Board. While they are not compensated for their positions as directors, they all will be compensated for their services as officers. Other than providing compensation amounts, you did not provide additional information for these positions including the description of the job requirements or the number of hours they work for you. While you have adopted a conflicts of interest policy, since the only Board members are the founding members, they are also the only ones who can determine compensation and are setting the compensation for themselves as officers. Your Articles of Incorporation do not include an inurement prohibition.

You represented that in setting compensation amounts you relied upon a national survey of non-profit organizations. A review of the financial information you submitted shows that the CEO will be paid \$x1. Your financial information shows your revenue will be as high as \$x2 with expenditures as high as \$x3. Using the information and survey you submitted, the CEO's compensation should not be more than \$x4. Similarly, the CFO is listed as making but the survey submitted shows \$x5 (based on the national average). The other two positions are not listed in the survey. You did not provide an explanation as to how you determined that deviations were appropriate from the amount contained in the survey. You also did not provide any information on how you determined the compensation for the positions not included in the survey. In addition to their annual salary, the

Board can grant bonuses of up to 20 percent of base salary. You did not provide a description of the criteria that will be used in determining bonuses, including the amount and eligibility.

### **LAW**

Section 501(a) of the Code provides that organizations described in subsection (c) shall be exempt from taxation. Subsection (c)(3) includes corporations organized and operated exclusively for charitable, religious, and educational purposes. Furthermore, the aforementioned subsection requires that no part of the organization's net earnings inure to the benefit of any private shareholder or individual, that no substantial part of its activities is to influence legislation, and that it does not participate in any political campaign on behalf of or in opposition to any candidate for public office.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations ("regulations") provides that to be exempt as an organization described in § 501(c)(3) an organization must be both organized and operated exclusively for purposes specified in said section of the Code. If an organization fails to meet either test, it is not exempt.

Section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated for an exempt purpose unless it serves a public rather than a private interest.

Rev. Rul. 71-529, 1971-2 C.B. 234, holds that a nonprofit organization that provides assistance in the management of participating colleges' and universities' endowment or investment funds for a charge substantially below cost, qualifies for exemption under § 501(c)(3). In said case, membership in the organization was restricted to colleges and universities exempt under § 501(c)(3) and its services were provided only to the exempt organizations that controlled it. In this case the fees paid by the participating colleges and universities represented less than fifteen percent of total costs.

Rev. Rul. 72-369, 1972-2 C.B. 245, holds that an organization formed to provide managerial and consulting services at cost to unrelated exempt organizations does not qualify for exemption under § 501(c)(3). Here, the Service stated that providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit. The fact that the services here were provided at cost and solely to exempt organizations was not sufficient to characterize the activity as charitable within the meaning of § 501(c)(3).

Section 4.03 of Revenue Procedure 2012-9, 2012-2 I.R.B. 261 provides, in pertinent part, as follows:

Exempt status will be recognized in advance of operations if proposed operations can be described in sufficient detail to permit a conclusion that the organization will clearly meet the particular requirements of the section under which exemption is claimed. (1) A mere restatement of purposes will not satisfy this requirement. (2) The organization must fully describe the activities in which it expects to engage, including the standards, criteria, procedures, or other means adopted or planned for carrying out the activities, the anticipated sources of receipts, and the nature of contemplated expenditures. (3) Where the organization cannot demonstrate to the satisfaction of the Service that it qualifies for

exemption pursuant to the Section of the Internal Revenue Code under which exemption is claimed, the Service will generally issue a proposed adverse determination letter or ruling.

In Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945), the Supreme Court stated that the presence of a single nonexempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes. This case is the basis of § 1.501(c)(3)-1(c)(1) which provides that an organization will be regarded as “operated exclusively” for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in § 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities are not in furtherance of an exempt purpose.

In Airlie Foundation v. Commissioner, 283 F. Supp. 2d 58 (D.D.C. 2003), the court concluded that an organization did not qualify for tax-exemption under § 501(c)(3) because it was operated for nonexempt commercial purposes rather than for exempt purposes. Among the major factors the court considered in reaching this conclusion was the organization’s competition with for-profit commercial entities, the extent and degree of below cost services provided, the pricing policies, and the reasonableness of financial reserves. Additional factors included whether the organization used commercial promotional methods, such as advertising, and the extent to which the organization received charitable donations.

The organization has the burden of providing sufficient documentation or other substantive information regarding its activities and operations, which would establish entitlement to tax exempt status, including establishing that its net earnings will not inure to the benefit of private individuals and that it will not serve private interests. Founding Church of Scientology v. United States, 412 F.2d 1197, 1200, 1202 (Ct.Cl. 1969).

In Federation Pharmacy Services, Inc. v. Commissioner, 72 TC. 687 (1979), the court upheld the Commissioner’s denial of exemption under § 501(c)(3). The organization was organized to operate a pharmacy to sell drugs at discount prices to elderly and handicapped persons. It had no commitment to use excess receipts to provide drugs for free or below cost to the elderly and handicapped. The organization served elderly and handicapped almost exclusively, and did not sell toiletries articles, magazines, cards, or other items normally sold for profit by pharmacies. The organization’s board consisted of community leaders, none of whom obtained any personal financial benefit from participation. The organization used the services of volunteers (for mailing prescriptions, completing patient profiles, maintenance, etc.) instead of paid employees. All gifts were used for the benefit of financially distressed senior citizens who, because of catastrophic illness or accident, incurred large prescription drug bills. The court reasoned that the organization operated its business primarily for commercial purposes, in competition with profit making drug stores. The fact that products sold by the organization were helpful to health did not necessarily entitle it to exemption under § 501(c)(3).

In Bubbling Well Church of Universal Love v. Commissioner, 74 T.C. 531, 535 (1980) aff’d, 670 F.2d 104 (9th Cir. 1980), the Tax Court noted that an application for exemption “calls for open and candid disclosure of all facts bearing upon petitioner’s organization, operations, and finances so that the Court, should it uphold the claimed exemption, can be assured that it is not sanctioning an abuse of the revenue laws. If such disclosure is not made, the logical inference is that the facts, if disclosed, would show that petitioner fails to meet the requirements of section 501(c)(3).”



## ANALYSIS

To qualify for exemption under § 501(c)(3), a taxpayer must demonstrate that it is both organized and operated exclusively for exempt purposes. § 501(c)(3); § 1.501(c)(3)-1. You are not operated exclusively for exempt purposes because you operate for a substantial non-exempt commercial purpose and your income may inure to the benefit of private shareholders. Finally, you did not provide adequate information to demonstrate that you are operated for exempt purposes.

You were formed to manufacture drugs to be sold in third world countries. Manufacturing pharmaceuticals is inherently a for-profit activity. To be considered exempt you must demonstrate that you will be able to sell your products substantially below your costs. See Airlie Foundation, 283 F. Supp. 2d 58 (concluding that an organization did not qualify for § 501(c)(3) status because it was operated for nonexempt commercial purposes rather than for exempt purposes); Federation Pharmacy Services, 72 TC. 687 (denying § 501(c)(3) status because the organization operated a business primarily for commercial purposes, in competition with profit making drug stores); Rev. Rul. 71-529, supra (holding that a nonprofit organization that provides assistance in the management of participating colleges' and universities' endowment or investment funds for a charge substantially below cost, qualifies for exemption under § 501(c)(3)); and Rev. Rul. 72-369, supra (holding that an organization formed to provide managerial and consulting services at cost to unrelated exempt organizations does not qualify for exemption under § 501(c)(3)). While you have stated that your goal is to provide pharmaceuticals below cost, you have not demonstrated that in actuality your products will always be sold at prices substantially below your cost. Rather, you have stated that your sales price will be based on the operational costs if not fully recovered by donations.

An organization is also not considered to be operated exclusively for exempt purposes if any of its net earnings inure to the benefit of private shareholders or individuals with a personal and private interest in its activities. § 501(c)(3); § 1.501(c)(2)-1(c); § 1.501(c)(3)-1(c)(2); § 1.501(c)(3)-1(d)(1)(ii). Inurement of net earnings may occur through a wide range of means and is not limited to the actual distribution of dividends or payment of excessive salaries. Founding Church of Scientology, 412 F.2d at 1200.

Your four founders have life time terms as members of your Board of Directors. The life appointment of your founders to the Board of Directors confers upon them the right to control your operations in a similar fashion as majority stockholders in a for-profit corporation, including determining their own compensation. Although Board members will not be compensated for their activities as directors, they will be compensated as officers. You stated that you relied upon surveys in determining your compensation amounts, but did not explain why you determined compensation should be greatly above the amounts listed in the survey or how you set compensation for the positions not described in the survey. Additionally, these officers all may receive bonus amounts equaling 20% of their base salary. You did not provide any information on the circumstances in which an individual would be entitled to such a bonus. The potential of inurement by the lifetime members of your Board clearly would be in violation of the provisions of §

501(c)(3) in a corporation in which the founders have a lifetime membership in your Board and control of determining their own compensation and benefits.

Finally, an application for tax-exempt status "calls for open and candid disclosure of all facts bearing upon [an Applicant's] organization, operations, and finances to assure [that there is not] abuse of the revenue laws. If such disclosure is not made, the logical inference is that the facts, if disclosed, would show that the [Applicant] fails to meet the requirements of section 501(c)(3)." Bubbling Well Church of Universal Love, 74 T.C. at 535. See also, Founding Church of Scientology, 188 Ct. Cl. at 498. As provided in § 4.03 of Rev. Proc. 2012-9, supra, in order to recognize you as an exempt under § 501(c)(3) prior to the initiation of your operations you must provide a detailed description of your activities in order to arrive to the conclusion that you will meet the requirements under said section.

You were unable to substantiate that your operations will meet the requirements under §501(c)(3) we are unable to recognize you as an exempt organization. You did not describe the pharmaceuticals you will manufacture, the location you will conduct your manufacturing, your pricing structure, your employees, any governmental approval for your operations as a pharmaceutical manufacturing plant, your relationships with any non-profits for distribution purposes, or the information surrounding the compensation of your Directors.

Based on the foregoing, we conclude that you are operated for a substantial nonexempt commercial purpose; that is, manufacturing and selling pharmaceutical products. You were not able to substantiate your representations that these products will be sold or provided at substantially below cost. As in Federation Pharmacy Services, 72 TC. 687, you are operated primarily for a commercial purpose. In Better Business Bureau, 326 U.S. at 283, the Supreme Court clearly stated that the presence of a single and substantial nonexempt purpose will prevent an organization from recognition as an exempt organization under § 501(c)(3). Furthermore, the control of the founders over your operations offer an opportunity for your net earnings inure to their benefit, in contravention of the provision violation in § 501(c)(3).

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under § 170.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination.

Your protest statement should be accompanied by the following declaration:

*Under penalties of perjury, I declare that I have examined this protest statement, including accompanying documents, and, to the best of my knowledge and belief, the statement contains all the relevant facts, and such facts are true, correct, and complete.*

You also have a right to request a conference to discuss your protest. This request should be made when you file your protest statement. An attorney, certified public accountant, or an



individual enrolled to practice before the Internal Revenue Service may represent you. If you want representation during the conference procedures, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. For more information about representation, see Publication 947, *Practice before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at [www.irs.gov](http://www.irs.gov), Forms and Publications.

If you do not file a protest within 30 days, you will not be able to file a suit for declaratory judgment in court because the Internal Revenue Service (IRS) will consider the failure to protest as a failure to exhaust available administrative remedies. Section 7428(b)(2) provides, in part, that a declaratory judgment or decree shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted all of the administrative remedies available to it within the IRS.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848 and any supporting documents to this address:

Internal Revenue Service  
ATTN:  
SE:T:EO:RA:T  
NCA:  
1111 Constitution Ave, N.W.  
Washington, DC 20224-0002

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Lois G. Lerner  
Director, Exempt Organizations